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C. DUKES SCOTT
EXECUTIVE DIRECTOR

P.O. Box 11263
Columbia, S.C. 29211



Phone: 803-737-0800
Fax: 803-737-0301

DAN EARNETT
CHIEF OF STAFF

KATIE C. MORGAN
DIRECTOR
TELECOMMUNICATIONS, TRANSPORTATION, WATER/WASTEWATER

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COMMISSION

October 5, 2006

Charles L.A. Terreni, Esquire
Chief Clerk and Administrator
Public Service Commission of South Carolina
101 Executive Center Dr., Suite 100
Columbia, South Carolina 29210

RE: Docket No. 1997-239-C Universal Service Fund Audit

Dear Mr. Terreni:

As required by the guidelines approved in South Carolina Public Commission Order No. 2001-996, the Office of Regulatory Staff contracted with an independent third party auditor, Scott McElveen, L.L.P, to conduct an annual audit of the financial statements of the South Carolina Intrastate Universal Service Fund. The audit for the period January 1, 2005 – December 31, 2005 has recently been completed. The results of this audit are enclosed and are also available on the Office of Regulatory Staff web site at www.regulatorystaff.sc.gov.

Sincerely,

Katie C. Morgan

Enclosure

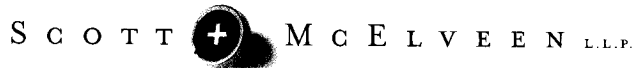
Report on Audits of Financial Statements

South Carolina Universal Service Fund

*for the year ended December 31, 2005
and for the period from
inception (October 10, 2001) to December 31, 2004*

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Independent Auditors' Report

South Carolina Office of Regulatory Staff
Columbia, South Carolina

We have audited the accompanying balance sheets/statements of net deficit of the South Carolina Universal Service Fund (the "Fund") as of December 31, 2005 and 2004, and the related statements of revenues, expenses and changes in fund deficit/statements of activities, which collectively comprise the Fund's basic financial statements for the year ended December 31, 2005 and the period from inception (October 10, 2001) to December 31, 2004. These financial statements are the responsibility of the Fund's management. Our responsibility is to express opinions on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Governmental Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinions.

As discussed in Note 1, the financial statements of the Fund are intended to present the financial position and results of operations of the Fund and do not purport to and do not present fairly the financial position of the State of South Carolina and the changes in its financial position or cash flows for the periods then ended in conformity with accounting principles generally accepted in the United States of America, and do not include any other agencies, divisions or component units of the State of South Carolina.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Fund as of December 31, 2005 and 2004, and the results of its operations for the year and initial period then ended in accordance with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the financial statements of the Fund. The supplementary information included as Management's Discussion and Analysis on pages 3 thru 6 is presented for purposes of additional analysis and is not a required part of the financial statements referred to in the first paragraph. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

CERTIFIED PUBLIC ACCOUNTANTS

Member: AICPA, SCACPA, SEC Practice Section
An Independent Member of the BDO Seidman Alliance

1441 Main Street, Suite 800 TEL (803) 256-6021
Post Office Box 8388 FAX (803) 256-8346
Columbia, South Carolina 29202 www.scottmcelveen.com

In accordance with *Government Auditing Standards*, we have also issued a report dated August 18, 2006, on our consideration of the Fund's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audits.

Scott McElveen, L.L.P.

Columbia, South Carolina
August 18, 2006

Required Supplementary Information

South Carolina Universal Service Fund Management's Discussion and Analysis

Management's Discussion and Analysis ("MD&A") is prepared by the South Carolina Office of Regulatory Staff (the "SCORS") management to provide general information on the financial activities of the Fund. The MD&A should be read in conjunction with the Fund's financial statements and accompanying notes. The financial statements, notes, and this discussion are the responsibility of the SCORS's management.

The SCORS is an independent regulatory agency of the State of South Carolina that is responsible for the regulation of public utilities, including electric, natural gas, transportation, water/wastewater and telecommunications. The SCORS receives its authority and responsibilities from the State Legislature. One of the SCORS's responsibilities is to administer the Fund. The Fund was established to ensure the widespread availability of affordable local exchange telephone service. The South Carolina Public Service Commission ("SCPSC") administered the Fund from its inception until January 11, 2005 when responsibility for the Fund's administration was transferred to SCORS.

This section of the Fund's financial report represents our discussion and analysis of the financial performance during the periods presented. It should be read in conjunction with the Fund's financial statements, which follow this section.

OVERVIEW OF THE FINANCIAL STATEMENTS

The Fund is accounted for as a special revenue fund, which is a governmental fund that uses the flow of current financial resources and the modified accrual basis of accounting. The financial statements provide a detailed view of the Fund's finances that assists in determining whether there will be adequate resources available to meet the needs of the Fund. The Fund's financial statements include two statements:

The Balance Sheets/Statements of Net Deficit present only assets expected to be used and liabilities that come due during the year or soon thereafter. The difference between assets and liabilities is reported as fund deficit/net deficit.

The Statements of Revenues, Expenditures, and Changes in Fund Deficit/Statements of Activities present a comparison of revenues for which cash is received during or soon after the end of the year; expenditures for which payment is due during the year or soon thereafter; and other financing sources and uses, such as transfers to the General Fund. The net of these categories increases or decreases the fund balance.

For the purposes of the Fund, there are no reconciling items between the fund financial statements and the presentation on an entity-wide basis. Accordingly, the financial statements have been presented in a combined format as permitted by the Governmental Accounting Standards Board ("GASB") No. 34, "Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments" and amendments.

This annual report consists of two parts – management's discussion and analysis and the basic financial statements. The MD&A provides comparative analysis of the Fund's activity. The basic financial statements also include notes that explain key information contained in the financial statements and provide further details on select data.

FINANCIAL HIGHLIGHTS

- The Fund's fund deficit/net deficit as of December 31, 2005 and 2004 was \$595,855 and \$862,416, respectively. This deficit was created during the inception period, and management is currently taking steps to eliminate this deficit.

CURRENTLY KNOWN FACTS/ECONOMIC FACTORS

- Telecommunications companies' regulated revenues reported during Fund Year 2005 were down significantly. This could be due to changes in the telecommunications market. Consumers seem to be migrating toward wireless telephony rather than traditional wire-line telephony. Another major reason for the decline in reported revenue is related to changes in reporting requirements implemented by the Federal Communication Commission ("FCC"). For example, the FCC now allows companies to adjust revenues for uncollectible amounts. Because the Fund's enabling legislation requires that the Fund not be inconsistent with the federal fund, these changes were recognized at the state level.
- There continues to be a lot of change in the telecommunications industry with numerous companies entering and exiting the market. This constant change along with various mergers and acquisitions, poses challenges for the administrators of the Fund. Several companies that were contributing to the Fund have filed for bankruptcy protection during the past 24 months, while others have effectively removed themselves from the market. In addition, as mergers and acquisitions take place, there is a question as to the liability of the acquiring company for the acquired company's debt to the Fund. To assist in administering the Fund, a declaratory order from the SCPSC was requested to further define the administrator's authority to make adjustments, give credits and to otherwise handle these varied situations. An order was provided July 3, 2006 that affords the SCORS some flexibility resolving these issues in the future.

Financial Analysis of the Fund

The Balance Sheets/Statements of Net Deficit and the Statements of Revenues, Expenditures and Changes in Fund Deficit/Statements of Activities provide an indication of the Fund's financial condition and also indicate the financial condition of the Fund since inception. The Fund's fund deficit reflects the difference between assets and liabilities. A decrease in fund deficit or an increase in fund balance over time typically indicates an improvement in financial condition.

Balances Sheets/Statements of Net Deficit as of December 31,

	<u>2005</u>	<u>2004</u>
Assets		
Cash and cash equivalents	\$ 5,185,865	\$ 6,855,352
Accounts receivable, less allowance for doubtful accounts in 2005 and 2004 of \$446,610 and \$657,416, respectively	2,768,855	1,103,232
Due from SCORS	19,106	—
Total assets	<u>\$ 7,973,826</u>	<u>\$ 7,958,584</u>
Liabilities and Fund Deficit/Net Deficit		
Accounts payable	\$ 8,561,711	\$ 8,821,000
Other liabilities	7,970	—
Total liabilities	<u>8,569,681</u>	<u>8,821,000</u>
Fund Deficit/Net Deficit		
Unreserved fund deficit/net deficit	(595,855)	(862,416)
Total fund deficit/net deficit	(595,855)	(862,416)
Total liabilities and fund deficit/net deficit	<u>\$ 7,973,826</u>	<u>\$ 7,958,584</u>

**Statements of Revenues, Expenditures and Changes in Fund Deficit/Statement of Activities
for the**

	Year ended December 31, 2005	Period from inception (October 10, 2001) to December 31, 2004
Revenues		
Contributions	\$53,008,785	\$143,663,000
Late payment assessments	—	89,000
Total revenues	<u>53,008,785</u>	<u>143,752,000</u>
Expenditures/Expenses		
Telecommunication service providers	52,828,165	143,957,000
General and administrative expenditures/expenses	124,865	—
Bad debt (recoveries) expenditures/expenses	(210,806)	657,416
Total expenditures/expenses	<u>52,742,224</u>	<u>144,614,416</u>
Excess (deficiency) of revenues over (under) expenditures/Changes in net deficit	<u>266,561</u>	<u>(862,416)</u>
Fund deficit/net deficit, at beginning of year	(862,416)	—
Fund deficit/net deficit, at end of year	<u>\$ (595,855)</u>	<u>\$ (862,416)</u>

The amount reported as excess of revenues over expenditures/changes in net deficit increased by \$1,128,977, from (\$862,416) to \$266,561, because the increase in revenues outpaced the increase in expenditures/expenses. This increase is also due to the recoveries of bad debt expense which had previously been reserved in the prior period. The current year increase resulted in a 31 percent decrease of the unreserved fund deficit/net deficit.

Request for Information

The primary purpose of this financial report is to provide a general overview of the Fund's finances and to demonstrate the Fund's accountability for the money it receives and spends. Questions concerning any of the information provided in this report or requests for additional information should be addressed to:

South Carolina Office of Regulatory Staff
Attn.: Universal Service Fund Administrator
1441 Main Street, Suite 300
Columbia, SC 29201

Financial Statements

South Carolina Universal Service Fund
Balance Sheets/Statements of Net Deficit
as of December 31,

	<u>2005</u>	<u>2004</u>
Assets		
Cash and cash equivalents	\$ 5,185,865	\$ 6,855,352
Accounts receivable, less allowance for doubtful accounts in 2005 and 2004 of \$446,610 and \$657,416, respectively	2,768,855	1,103,232
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Unreserved fund deficit/net deficit	<u>(595,855)</u>	<u>(862,416)</u>
Total fund deficit/net deficit	<u>(595,855)</u>	<u>(862,416)</u>
Total liabilities and fund deficit/net deficit	<u>\$ 7,973,826</u>	<u>\$ 7,958,584</u>

The accompanying notes are an integral part of these financial statements.

South Carolina Universal Service Fund
Statements of Revenues, Expenditures and Changes in Fund Deficit/
Statements of Activities
for the

	Year ended December 31, 2005	Period from inception (October 10, 2001) to December 31, 2004
Revenues		
Contributions	\$ 53,008,785	\$ 143,663,000
Late payment assessments	—	89,000
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Total expenditures/expenses	<u>52,742,224</u>	<u>144,614,416</u>
Excess (deficiency) of revenues over (under) expenditures/Change in net assets	<u>266,561</u>	<u>(862,416)</u>
Fund deficit/net deficit, at beginning of year	(862,416)	—
Fund deficit/net deficit, at end of year	<u>\$ (595,855)</u>	<u>\$ (862,416)</u>

The accompanying notes are an integral part of these financial statements.

South Carolina Universal Service Fund
Notes to Financial Statements

Note 1. Summary of Significant Accounting Policies (continued)

Allowance for Doubtful Accounts – An allowance for doubtful accounts is recorded and reduces the carrying value of accounts receivable to its net realizable value. The amount of the allowance is based upon management's estimate of currently uncollectible accounts, historical trends, current economic trends, and other factors. Provisions to increase or decrease the allowance are charged to operations. During the year ended December 31, 2005, the Fund decreased its allowance for doubtful accounts based upon current year recoveries and changes in the management's estimate of the ultimate collectibility of certain accounts receivable balances.

Accounting Estimates – The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenditures and affect disclosure of contingent assets and liabilities at the balance sheet date and the reported amounts of revenues and expenditures during the reporting period. Accordingly, actual results could differ from those estimates.

Revenue Recognition – Telecommunications companies doing business in South Carolina are required to pay to the Fund a fixed monthly amount as determined in accordance with Fund guidelines. It is the Fund's policy to record revenues in the period earned.

Note 2. Deposits Held by State Treasurer

The deposits of the Fund held by the State Treasurer are under the control of the State Treasurer who, by law, has sole authority for investing State funds. State law requires full collateralization of all State Treasurer balances. The State Treasurer must correct any deficiencies in collateral within seven days.

With respect to investments in the State's internal cash management pool, all of the State Treasurer's investments are insured or registered or are investments for which the securities are held by the State or its agent in the State's name. Information pertaining to carrying amounts, fair value, credit and other risks as required by Governmental Accounting Standards Board Statement No. 40 Deposits and Investments – Risk Disclosures, of the State Treasurer's investments are disclosed in the Comprehensive Annual Financial Report of the State of South Carolina.

Deposits at fair value at December 31, 2005 and 2004 held by the State Treasurer are \$8,646,379 and \$6,371,825, respectively.

Note 3. Income Taxes

These financial statements present the activities of the Fund. The activities of the Fund are tax-exempt since the Fund is a special revenue fund of the state of South Carolina; therefore, not subject to federal or state income taxes or sales, use, gross receipts or other taxes. As such, no provisions for such taxes have been reflected in the accompanying financial statements.

South Carolina Universal Service Fund
Notes to Financial Statements

Note 4. Assessments

Identified carriers that are operating in the State of South Carolina, excluding wireless service providers, provide assessments to the Fund. The SCORS searches publicly available resources to identify carriers operating in the state of South Carolina that are not providing assessments to the Fund. The carriers are assessed based upon the weighted average of their total revenues compared to the total revenues of all telecommunication companies operating in the State. The total assessment for the year ended December 31, 2005 and for the period from inception (October 10, 2001) to December 31, 2004 was \$53,008,785 and \$143,663,000, respectively.

Note 5. Amounts Paid and Due to Telecommunication Service Providers

Payments to the qualified recipients are made by South Carolina Treasurer's office as directed by the SCORS. The qualified recipients receive payments in order to neutralize the revenue deficits created by mandated decreases in access charges in addition to high cost support as determined by the SCPSC. For the year ended December 31, 2005 and for the period from inception (October 10, 2001) to December 31, 2004, the Fund determined that \$52,828,165 and \$143,957,000, respectively in support payments were due to service providers.

Note 6. Related Parties

The Fund is administered by the SCORS as set forth by the State of South Carolina Act 175 of 2004. During the current year, the SCORS incurred general and administration expenditures/expenses totaling \$124,865 related to administration of the Fund. Related to these expenditures/expenses, the Fund reimbursed the SCORS \$143,971, and accordingly, the Fund has recorded a receivable from the SCORS in the amount of \$19,106 as of December 31, 2005. In the prior year, the SCPSC provided these services to the fund without any associated charges. Accordingly, the Fund did not recognize expenditures/expenses for these services provided by the SCPSC.

Note 7. Fund Deficit/Net Deficit

As of December 31, 2005, the Fund had a deficit of approximately \$595,855. The Fund plans to eliminate this deficit through future revenues and collections.

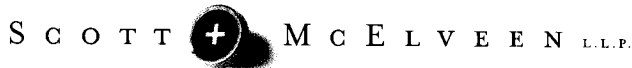
Note 8. Commitments and Contingencies

In 2001 and 2002, the Public Service Commission Orders that established and sized the Fund were appealed by two separate parties. Following a decision in favor of the Fund at the Circuit Court level, the cases were then appealed to the South Carolina Supreme Court. The cases were briefed and argued before the Supreme Court in October 2003. The parties to these cases are awaiting a decision from the Supreme Court that could be rendered at any time. Should the Supreme Court rule against the sizing or establishment of the Fund, the ruling could have a significant effect on the Fund's financial statements.

Subsequent appeals have also been filed concerning either sizing or requests for additional funds by the Fund. These cases have been stayed pending the decision from the Supreme Court in the initial cases discussed above.

The Fund has also received notice of claims from telecommunication companies which have filed for bankruptcy protection in various jurisdictions. Judgment against the Fund in these cases could result in additional liability of the Fund of over \$60,000.

Report on Internal Control Over Financial
Reporting and on Compliance and Other Matters
Based on an Audit of Financial Statements
Performed in Accordance with
Government Auditing Standards



**Report on Internal Control over Financial Reporting and on Compliance and Other
Matters Based on an Audit of Financial Statements Performed in Accordance with
*Government Auditing Standards***

South Carolina Office of Regulatory Staff
Columbia, South Carolina

We have audited the accompanying balance sheets/statements of net deficit of the South Carolina Universal Service Fund (the "Fund") as of December 31, 2005 and 2004, and the related statements of revenues, expenses and changes in fund balance/statements of activities, which collectively comprise the Fund's basic financial statements for the year ended December 31, 2005 and the period from inception (October 10, 2001) to December 31, 2004 and have issued our report thereon dated August 18, 2006. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Fund's internal control over financial reporting in order to determine our auditing procedures for expressing our opinions on the financial statements and not to provide an opinion on the internal control over financial reporting. However, we noted matters involving internal control over financial reporting and its operations that we consider reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Fund's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. The reportable conditions are discussed on page 14.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of internal control would not necessarily disclose all matters in internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered material weaknesses. However, we consider none of the items noted on page 14 to be material weaknesses.

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1441 Main Street, Suite 800 TEL (803) 256-6021
Post Office Box 8388 FAX (803) 256-8346
Columbia, South Carolina 29202 www.scottmcelveen.com

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Fund's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance or other matters required to be reported under *Government Auditing Standards* as discussed on page 14.

This report is intended solely for the information and use of the South Carolina Office of Regulatory Staff, the South Carolina Public Service Commission and other agencies of the State of South Carolina, and is not intended to be, and should not be used by anyone other than these specified parties.

Scott McElveen, L.L.P.

Columbia, South Carolina
August 18, 2006

Reportable Conditions and/or Violations of State Laws, Rules, or Regulations

Improper Allocation of Billings to Fund Revenue Providers

Condition:

Certain instances were noted where the revenue amounts used in the Fund billing allocation determination did not agree with the amount reported to the Fund on the contribution worksheets provided by the entities which provide revenue to the Fund.

Cause:

This was an oversight of the SCPSC during the last resizing of the Fund prior to the SCORS accepting the administrative function of the Fund.

Effect:

The billing allocation to the revenue providers of the Fund was improperly prepared.

Criteria:

The Administrator should ensure that the revenue used in the billing allocation agrees to amounts included on the contribution worksheets provided by the entities which provide revenue to the Fund.

Recommendation:

It is recommended that the Administrator implement policies and procedures whereby the information used in the billing allocation matches the actual supporting documentation.

Implement closing procedures

Condition:

At the start of the audit, we were provided with a trial balance that included information pertaining only to the period the Fund was managed by the SCORS. Prior year balances, information pertaining to the Fund's operations prior to the date the SCORS assumed Fund management, the allowance for doubtful accounts and accounts payable were not included.

Cause:

Management did not properly account for the Fund as an ongoing entity that transcends the management by the SCPSC and the SCORS.

Effect:

The trial balance maintained by the Fund was not prepared in accordance with accounting principles generally accepted in the United States of America. As such, we had to return the trial balance to management for correction.

Criteria:

The accounting records of the Fund should be maintained seamlessly, in accordance with accounting principles generally accepted in the United States of America, regardless of the management of the Fund.

Recommendation:

We recommend that the Fund's accounting department work to improve its year-end closing and reporting processes.

Status of Prior Material Weaknesses and/or Violations of State Laws, Rules, or Regulations

During the current year, we reviewed the status of corrective action taken on the findings reported as material weaknesses for the period from inception (October 10, 2001) to December 31, 2004. We determined that the Fund has taken adequate corrective action on each of the findings except for the following item which has been repeated above.

Period from inception (October 10, 2001) to December 31, 2004 Comment

Improper Allocation of Billings to Fund
Revenue Providers

December 31, 2005 Comment

Improper Allocation of Billings to Fund
Revenue Providers

C. DUKES SCOTT
EXECUTIVE DIRECTOR

P.O. Box 11263
Columbia, S.C. 29211



Phone: (803) 737-0800
Fax: (803) 737-0801

DAN F. ARNETT
CHIEF OF STAFF

KATIE C. MORGAN
DIRECTOR
TELECOMMUNICATIONS, TRANSPORTATION, WATER/WASTEWATER

September 22, 2006

Mr. Don Mobley
Scott McElveen, L.L. P.
PO Box 8388
Columbia, SC 29202

Dear Mr. Mobley:

This letter is in response to your audit of the South Carolina Universal Service Fund as of December 31, 2005 and 2004 and for the periods then ending. As illustrated in the audit, the Office of Regulatory Staff has made many improvements in the administration of the Fund and will continue to streamline our processes. Listed below are our responses to the reportable conditions cited in your audit.

Improper Allocation of Billings to Fund Revenue Providers

Management agrees with this finding. In certain instances, revenue information from carrier worksheets was input incorrectly into the spreadsheet developed in 2004 that was utilized for fund resizing. This spreadsheet was utilized by ORS in 2005 for Fund administration. ORS subsequently identified the errors and corrected them. Management has implemented new procedures to ensure that revenue information from the carrier worksheets is accurate and is keyed correctly.

Implement Closing Procedures

Management agrees that the financial records of the South Carolina Universal Service Fund should represent the activities of the Fund since its inception rather than the time period it was managed by the Office of Regulatory Staff. Actions have been taken to ensure future closing packages will reflect this understanding.

The Office of Regulatory Staff is committed to being a good steward of this Fund. We appreciate the professionalism of your staff and the assistance they provide in helping us meet this goal.

Sincerely,


Katie C. Morgan
Fund Administrator

C. DUKES SCOTT
EXECUTIVE DIRECTOR

P.O. Box 11963
Columbia, S.C. 29211



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DAN FARNETT
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TELECOMMUNICATIONS, TRANSPORTATION, WATER/WASTEWATER

October 5, 2006

Charles L.A. Terreni, Esquire
Chief Clerk and Administrator
Public Service Commission of South Carolina
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RE: Docket No. 1997-239-C Universal Service Fund Audit

Dear Mr. Terreni:

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Sincerely,

Katie C. Morgan

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